



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

**DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224**

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Employer Identification Number:
Person to Contact and ID Number:
Contact Telephone Number:
FAX Number:

Dear

This is in response to your request dated August 1, 2011, for rulings as to whether your establishment of a central counterparty structure pursuant to which you will become the central counterparty to transactions that take place in the markets you administer will affect your status as an organization described in section 501(c)(4) of the Internal Revenue Code (the "Code") or will give rise to income from an unrelated trade or business within the meaning of section 513(a).

Facts

You are recognized as an organization exempt from Federal income tax under section 501(c)(4) of the Code. You are operated exclusively for the promotion of social welfare.

You were formed as an independent system operator ("ISO") for a geographic region in a particular state. As such, you are certified by the state public utility commission (the "state PUC") and required by state law to perform the following functions: (i) ensure non-discriminatory access to the transmission and distribution systems for all electricity buyers and sellers; (ii) ensure the reliability and adequacy of the regional electric network; (iii) ensure that information related to customer retail choice is provided in a timely manner; and (iv) ensure that electricity production and delivery are accurately accounted for among all regional generators and wholesale buyers and sellers in the area. The state PUC exercises control over your organization by, for example, approving your budget, any changes to your operating documents, your operations plan, and your specific operational protocols ("Protocols").

Collectively, your activities are designed to ensure that the electricity consuming public has the amount of cost effective electricity they need to operate their homes and businesses. In furtherance of these activities, you administer markets for the wholesale purchase and sale of electric energy and related products and services which serve the state. In order to cover your operating expenses, you collect fees from the producers and wholesale purchasers of electric power in your region. These fees as well as the rules and procedures for the electricity markets you administer are set forth in substantive rules promulgated by the state PUC and your state PUC-approved Protocols. The contracts, agreements or transactions offered under the state rules and your state PUC-approved Protocols are for the purchase and sale of electric energy and related products and services, including related financial transactions which do not involve physical delivery of electricity.

The transactions you administer are not structured as direct bilateral contracts, i.e., individual purchase and sale contracts between a particular seller and a particular purchaser. Rather, you administer central markets for the benefit of market participants. Each market participant has established a settlement account with you, and you settle the various positions of the market participants on an aggregate basis. While you act as the administrator of the markets, clearing and settling purchases and sales by market participants, you do not take title to the electric energy and related products and services purchased and sold in the markets.

You are concerned about your ability, in the event of the bankruptcy of a market participant, to set off or net the market positions of the bankrupt market participant. Your concern is that you might not satisfy the "mutuality" requirement for setoff when those obligations are based upon different purchase and sale transactions because there is no single identifiable counterparty with whom the bankrupt market participant stands in privity of contract. When the costs attributable to the bankruptcy of a market participant cannot be collected from that participant they must be borne by all the market participants. This creates pricing inefficiencies that may ultimately be passed on to the rate-paying general public in your geographic region.

To address this concern, you intend to pursue Protocol amendments proposing to establish yourself as the central counterparty to all transactions in the markets you administer. Specifically, you will take title to the electric energy and related products and services purchased and sold in the markets, establishing privity between you and market participants. However, your role as central counterparty will not affect the clearing price, because the prices you pay to producers will exactly match the prices you receive from the wholesale purchasers. All transactions in which you will engage will be pursuant to state PUC-approved Protocols and the state rules.

You have represented that your activities as the central counterparty to transactions in the markets you administer (1) will not require an amendment to any of your organizing documents or any change to your organization; (2) will require only minor revisions to your Protocols; (3) will result in no net profit or loss to you; and (4) will not affect market clearing prices for electric energy and related products and services in the wholesale electric markets you administer.

You have determined that amending your state PUC-approved Protocols such that you will become the central counterparty to transactions in the markets you administer will protect the interests of both the wholesale electricity markets you administer and the rate-paying general public in the state. The Protocol amendments establishing you as central counterparty will be filed with your state PUC and will go into effect only if approved by the state PUC.

Rulings Requested

1. Your establishment and implementation of a central counterparty structure pursuant to which you will become the central counterparty to transactions consummated through the markets you administer will not adversely affect your status as an organization exempt from Federal income tax under section 501(c)(4) of the Code.
2. The revenues you receive by virtue of being the central counterparty to transactions consummated through the markets you administer will not be

classified as income from an unrelated trade or business within the meaning of section 513(a).

Law

Section 501(a) of the Code provides for the exemption from federal income tax of organizations described in section 501(c)(4) of the Code.

Section 501(c)(4)(A) of the Code describes civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 501(c)(4)(B) of the Code provides that an organization shall not be described in section 501(c)(4)(A) of the Code if any part of the net earnings of such entity inures to the benefit of any private shareholder or individual.

Section 511(a) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c)(4).

Section 512(a) of the Code states that the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the applicable deductions, and computed with the modifications in section 512(b)).

Section 513(a) of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the purpose or function constituting the basis for its exemption under section 501.

Section 1.501(c)(4)-1(a)(1) of the Income Tax Regulations ("Regulations") provides that an organization may be exempt as an organization described in section 501(c)(4) if it is not organized or operated for profit; and it is operated exclusively for the promotion of social welfare.

Section 1.501(c)(4)-1(a)(2)(ii) of the regulations provides, in relevant part, that an organization is not operated primarily for the promotion of social welfare if its primary activity is carrying on a business with the general public in a manner similar to organizations which are operated for profit.

Section 1.513-1(d)(1) of the regulations provides that gross income derives from "unrelated trade or business" within the meaning of section 513(a) of the Code if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income). A trade or business is "substantially related" only if the causal relationship is a substantial one. Thus, for

the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Rev. Rul. 66-148, 1966-1 C.B. 143, states that an organization formed for the purpose of establishing and maintaining a system for storage and distribution of water in order to increase underground water levels of a community is described in section 501(c)(4) as an organization operated exclusively for the promotion of social welfare. The organization's activities benefited all residents of the community whose wells were supplied by the raised water table. The organization was funded through assessments on water users in the community.

Rev. Rul. 74-361, 1974-2 C.B. 159, states that an organization that provides fire and rescue services for the general community qualified as a section 501(c)(3) organization because it lessened the burdens of government. The ruling also states that the organization also could have qualified as a section 501(c)(4) organization because it promoted social welfare.

Analysis

Ruling 1

You promote the common good and general welfare of the community as a whole by promoting the reliable and efficient operations of electric power systems in your geographic region, ensuring open access for all users of the region's transmission and distribution system on a non-discriminatory basis, coordinating these activities within the region, and performing the functions of an independent system operator within your state. The state has a significant voice in determining your activities and a continuing oversight role. Your authorizing state agency has delegated responsibility to you to develop rules to implement these activities.

Your establishment and implementation of a central counterparty structure pursuant to which you will become the central counterparty to transactions in the markets you administer, is a response to concern about your ability, in the event of the bankruptcy of a market participant, to set off or net the market positions of the bankrupt market participant. This inability would result in costs being borne by all market participants and the resulting pricing inefficiencies could burden the rate-paying public in your region.

Your activities as the central counterparty to transactions in the markets you administer will not require an amendment to any of your organizing documents or any change to your organization. Additionally, your activities as the central counterparty will result in no net profit or loss to you. Certain revisions to your state PUC-approved Protocols will be required for implementation of the central counterparty structure, but these revisions must be approved by the state PUC. Your role as a central counterparty will not affect the clearing price, because the prices you pay to producers will exactly match the prices you receive from the wholesale purchasers. Thus, your market processes will remain essentially the same.

By adopting the central counterparty structure, you seek to enhance the reliability and efficiency of the power system in your state, for the benefit of the rate-paying public. A default by one or more market participants can lead to a larger default in the market, disrupting services and the flow of electricity. By acting as the central counterparty, you will be able to offset the obligations of a defaulting participant against payments owed to that participant, reducing the impact of one

participant's default on the operations of other participants. The market participants are not able to do this themselves because of the clearing price system you use and the lack of contract privity with the defaulting party. Your sole purpose in acting as a central counterparty is to reduce the burden of a default on other market participants and the corresponding pricing inefficiencies that may be passed onto the rate-paying public. You will not generate any income from the activity. Additionally, the state's oversight role will continue to ensure that you will be operated in the manner for which you were established. Therefore, acting as a central counterparty will contribute to the common good and general welfare of the community, similar to the activities in Rev. Ruls. 66-148 and 74-361.

Accordingly, the implementation of the central counterparty structure, and your activities as the central counterparty on each transaction in the markets you administer, will not adversely affect your status as an exempt organization described in section 501(c)(4) of the Code as compared to your previous operations.

Ruling 2

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business which is not substantially related to the performance of an organization's exempt purpose. Section 1.513-1(d)(2) of the regulations states that a trade or business is substantially related to an organization's exempt purpose if it contributes importantly to the accomplishment of that purpose. As stated above, by acting as a central counterparty you will reduce the disruptions caused by a market participant's default and therefore the costs that must be borne by all market participants. This contributes importantly to the accomplishment of your exempt purposes of promoting the common good and general welfare of the community by reducing pricing inefficiencies that may ultimately be borne by the rate-paying general public. Therefore, acting as a central counterparty is substantially related to your exempt purpose and will not constitute an "unrelated trade or business within the meaning of section 513(a).

Rulings

1. Your establishment and implementation of a central counterparty structure pursuant to which you will become the central counterparty to transactions consummated through the markets you administer will not adversely affect your status as an organization exempt from Federal income tax under section 501(c)(4) of the Code.
2. The revenues you receive by virtue of being the central counterparty to transactions consummated through the markets you administer will not be classified as income from an unrelated trade or business within the meaning of section 513(a).

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or Regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your Federal income tax status, this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Manager, Exempt Organizations
Guidance Group 2

Enclosure
Notice 437